

The Recent U.S. Trade Deficit

—No Cause for Panic

GEOFFREY E. WOOD and DOUGLAS R. MUDD

ALARM has been mounting about the size of the U.S. trade deficit in 1977 and what seems in prospect for the deficit in 1978. The 1977 deficit has been described as the "largest in the Nation's history."¹ It has been implied that the trade surpluses of other countries, which are the counterpart of the U.S. deficits, are in some way harmful.

There is no reason to believe that this pattern of accumulating surpluses for the oil exporters and chronic deficits for the oil importers will be reversed in the near future. The grim conclusion . . . is that the OPEC countries will continue to pile up excess reserves . . . accumulating some \$250-\$300 billion in financial assets by 1980.²

It has been claimed that the deficit has "produced a loss in jobs."³

Perhaps as a consequence of these fears, policy has increasingly come to focus on reducing one component of the trade deficit as a means of halting the decline of the dollar.

But the balance of trade is only one aspect of a country's international economic relations, and there are circumstances when a trade deficit is highly desirable. Further, the fear that a trade deficit will aggravate national unemployment is erroneous. In terms of national economic policy, the recommendation to reduce one component of the deficit so as to strengthen the dollar would not be helpful.

¹Youssef M. Ibrahim, "\$26.7 Billion Trade Deficit, Fed by Oil Imports, Is Nation's Biggest," *New York Times*, January 31, 1978. The revised figure for the 1977 U.S. merchandise trade deficit is \$31.2 billion.

²U.S. Congress, Senate Committee on Foreign Relations, Subcommittee on Foreign Economic Policy, "International Debt, the Banks, and U.S. Foreign Policy," 95th Congress, 1st session, August 1977, p. 33.

³U.S. Congress, Joint Economic Committee, Subcommittee on International Economics, "Living With the Trade Deficit," 95th Congress, 1st session, November 18, 1977, p. 5.

The Balance of Merchandise Trade, the Balance of Trade, and the Balance of Payments

A country's exchange rate — that is, the value of its currency in terms of other currencies — will stay unchanged if the quantity of the currency supplied just equals the quantity demanded at the prevailing exchange rate. The exchange rate will rise when the quantity demanded exceeds quantity supplied and will fall when the quantity supplied exceeds quantity demanded.

Broadly speaking, the quantity of U.S. dollars supplied to foreign exchange markets in any year is made up of the dollars spent on imports, plus the amount of funds U.S. residents wish to invest outside the United States.⁴ The demand for U.S. dollars arises from the reverse of these transactions. Both exports by U.S. residents and the demand by foreigners to invest in the United States require that foreigners acquire dollars to spend in the United States.

Exports and imports comprise both goods (tangible items such as automobiles and wheat) and services (such as banking, insurance, transportation, and investment income). An export of services generates demand for dollars by foreigners just as does an export of goods, and the actual quantities involved in trade in services are very substantial. Net exports of these "invisibles" (as internationally traded services are known) in 1977 were \$15.8 billion, having grown fairly steadily from \$0.7 billion in 1966.

As shown in Table I, net exports of services by the United States have, over the past few years, turned

⁴U.S. importers supply dollars so as to purchase foreign currency to pay for imports, while investment abroad by U.S. residents creates demand for foreign currency because the foreign capital assets purchased — factories, stocks, government bonds, etc. — must be paid for in foreign currency.

Table I

U.S. BALANCE OF TRADE
(Millions of Dollars)

	Merchandise Trade Balance	Services Trade Balance	Balance on Goods and Services
1966	\$ 3,817	\$ 697	\$ 4,514
1967	3,800	595	4,395
1968	635	986	1,621
1969	607	395	1,002
1970	2,603	309	2,912
1971	- 2,260	1,920	- 340
1972	- 6,416	328	- 6,088
1973	911	2,609	3,520
1974	- 5,367	7,527	2,160
1975	9,045	7,119	16,164
1976	- 9,320	12,916	3,596
1977	-31,241	15,827	-15,414

Source: U.S. Department of Commerce

several deficits in trade in tangible goods into surpluses on total U.S. trade. Further, discussions of the 1977 trade deficit often are in terms of merchandise trade; when invisible trade is taken into account, the total trade deficit is much smaller.

Inflows of foreign funds are required to offset a trade deficit if the foreign exchange value of the dollar is to remain unchanged.⁵ It is useful to write that out in the form of an equation, where both exports and imports refer to *total* trade—that is, visibles plus invisibles—and private sector refers to the private sector in *both* the United States and abroad.

$$\text{Exports} + \text{Capital Inflows} = \text{Imports} + \text{Capital Outflows} \quad (1)$$

The left hand side of equation (1) is the private sec-

tor demand for dollars; the right hand side is the private sector supply.

Equation (1) can be rearranged in a number of ways; the most useful for the present purpose is as follows:

$$\text{Exports} - \text{Imports} = \text{Capital Outflows} - \text{Capital Inflows} \quad (2)$$

This rearrangement of the equation helps one to see that a trade deficit must, as a matter of arithmetic, be accompanied by a net importation of investment funds, that is, a "capital inflow" in the terminology of balance of payments accounting. *There cannot be one without the other; the United States cannot import funds without running a trade deficit.* The balance of payments must always be in balance.

In the absence of government transactions undertaken with the aim of changing the exchange rate, the exchange rate will adjust until the private sector's supply of U.S. dollars on the exchange market equals the quantity of dollars demanded by the private sector in that market.⁶

The fact that a trade deficit (with an unchanged exchange rate) implies a net capital inflow is vital in seeing the economic significance of the current trade deficit.

Trade Deficits — the Historical Record

The United States ran a trade deficit for a substantial part of the 19th century. Table II shows ten-year annual averages of U.S. trade deficits, as percentages of Net National Product, for the years 1869 to 1908, and for the years 1967 to 1977 on an annual basis.⁷

A noteworthy feature is that, taken as a percentage of Net National Product, last year's deficit was not markedly large by 19th century standards. Another

⁵An inflow of funds into a country for the purpose of investing there, whether the funds are for investment in bank deposits, securities, or even land, is described as an inflow of capital. An inflow of capital, to the extent that the capital is invested in financial assets, can be thought of as an export of securities. The term "capital inflow" *does not* refer to an inflow of capital goods, although the U.S. resident to whom the funds are lent can of course use them to buy capital goods abroad.

It may appear surprising that an inflow of funds, which can be spent on either consumption or capital goods, is described as an "inflow of capital." But an individual's capital is what can be spent in excess of current income; even if it has been lent to him, the capital is available for current expenditures. An inflow of funds into the United States is the result of foreigners deciding to lend to the United States, and their doing so lets the United States spend more than its current income, just as when an individual is lent funds he has acquired capital which enables him to spend in excess of current income.

⁶For a discussion of official transactions and a distinction between when they are intended to influence the exchange rate and when they are not, see Douglas R. Mudd, "International Reserves and the Role of Special Drawing Rights," this *Review* (January 1978), pp. 10-11.

⁷NNP is used in this comparison as this figure shows much better than GNP (which contains replacement investment) what is happening to national income after maintaining the nation's stock of real capital. Comparing the deficits to NNP, therefore, relates the deficits to what the nation can spend without depleting its accumulated stock of capital goods. (For the purpose of comparison, it may be useful to note that the 1977 deficit, 0.9 percent of NNP, is 0.8 percent of GNP.) Taking deficits as a percentage of NNP both compensates for inflation and relates the deficit to the income which is available to service the change in indebtedness which a deficit implies. Comparisons of deficits as percentages of NNP are therefore the most appropriate form of comparison over long time periods.

Table II

U.S. BALANCE OF TRADE RELATIVE TO
NET NATIONAL PRODUCT

Period	Balance on Goods & Services* (Millions of Dollars)	Net National Product* (NNP) (Millions of Dollars)	Balance as Percent of NNP
1869-1878	\$- 62	\$ 7,667	-0.8%
1879-1888	- 12	10,601	-0.1
1889-1898	4	12,049	0.03
1899-1908	353	20,540	1.7
1967	4,395	729,300	0.6
1968	1,621	794,700	0.2
1969	1,002	853,100	0.1
1970	2,912	891,600	0.3
1971	- 340	964,700	-0.04
1972	- 6,088	1,065,800	-0.6
1973	3,520	1,188,900	0.3
1974	2,160	1,275,200	0.2
1975	16,164	1,366,300	1.2
1976	3,596	1,527,400	0.2
1977	-15,414	1,693,100	-0.9

*Figures for the years 1869-1908 are ten-year averages.

Sources: National Bureau of Economic Research and U.S. Department of Commerce

notable feature of the data in Table II is the shift to a trade surplus that occurred as the century progressed. This implies that the United States was moving from being a substantial net importer of investment funds to being a net exporter.⁸ A major reason for this is that in the earlier part of the period, the United States was expanding westwards at a very rapid rate. That created a demand for investment to construct transportation facilities, develop farmlands, and so forth. The rate of return that could be earned on capital in the United States was significantly higher than that which could be earned in the rest of the world. The economy thereby became more industrialized and agriculture more mechanized. Only as the United States became relatively abundant in capital, towards the end of the 19th century, did the situation change and the United States become a capital exporter.

The Deficit and Inflows of Funds

As Table II shows, the United States reverted to the position of a net importer of investment funds in

⁸These investment funds were, it should be noted, actually used in large part to buy capital goods from abroad in the 19th century.

1977. The large increase in oil prices of recent years has provided some oil exporting countries with enormous ability to save out of current incomes. Naturally, they wish to invest these savings. That same increase in oil prices reduced spending power in the United States; people had to spend a larger portion of their incomes on oil, and had therefore less left for other purposes.

This means that it is quite rational for the United States to import investment funds at the present time; in other words, to attempt to borrow funds to pay for the increased imports. These funds allow U.S. consumers to adjust their consumption more smoothly — they are not forced to make a sharp change, which is always unpleasant and can be inefficient since it forces cuts in what is easiest, rather than most desirable.⁹

Further, and ultimately more important, the inflow of funds can make it easier for U.S. firms to invest. The inflow of funds represents an increase in the demand for U.S. securities. Unless the supply of these securities rises by at least the same amount as the increase in demand, the price of U.S. securities is bolstered by this inflow of investment funds, and U.S. interest rates are lower than they would otherwise have been.¹⁰ This increased ease in obtaining funds helps firms to invest, and thus encourages long-run growth in output, which is the only way the decline in U.S. living standards caused by the oil price increase can ultimately be reversed. Without the inflow of funds from the oil exporting countries, living standards would be lower and prospects of raising them bleaker than with the inflow.

The Deficit and Unemployment

Imports do not cause unemployment. Many imports into the United States are themselves used in U.S. exports. An example is imported steel. Steel can be obtained more cheaply abroad than in the United States, and the prices of U.S. exports which use steel reflect the lower input price. Restrictions designed to raise import prices would also raise U.S. export (and domestic) prices for those goods, as well as directing

⁹An example is a family which bought a new automobile just before the oil price increase. The family might want to change to one which used less gas, but initially would be stuck with the car and have to cut back on, say, clothing.

¹⁰It should be emphasized that there is not necessarily a net increase in investment as compared to what would have happened without the oil price increase. There is an increased incentive to invest, as compared to the hypothetical situation where oil prices had increased but there had been no inflow of funds from abroad.

to the production of steel resources which would more profitably be used elsewhere. The increase in U.S. export prices relative to world market prices would reduce U.S. exports and, hence, U.S. export production and U.S. employment in some exporting industries.

Imports into the United States also create income abroad. If imports were suddenly restricted, U.S. exporters would experience an associated drop in demand. Agriculture, an industry currently eager to export so as to boost income, is an example of an industry highly sensitive to foreign demand for its products.

Hence, imports create some job opportunities as part of the very process by which they reduce others. But, even if the United States used more labor in producing every good than any other country in the world, it would still be possible for the United States to participate in foreign trade, to gain from that trade, and not to suffer unemployment as a result.

That proposition is by no means new. It was demonstrated first in 1817 by the economist and stockbroker David Ricardo. Briefly, the reason why trade cannot permanently cause unemployment is that when workers are displaced from one job by competition from elsewhere, they can move on to another job. It does not matter whether the competition is at home or abroad. If some goods are being produced and sold more cheaply than before, consumers, and also producers of these goods, have increased income and thereby increased demand for other products.¹¹

That is not of course to say that engaging in international trade cannot cause a temporary fluctuation in unemployment. There can be temporary unemployment as workers move around while some industries expand and others decline.¹² But if trade is restricted to eliminate that type of unemployment, the economy is frozen in a wasteful pattern of production, just as if, when the automobile started to displace the horse

and carriage, automobile production had been made illegal to protect the carriage-making industry.¹³

Accordingly, a trade deficit cannot permanently cause unemployment, *if there are no domestic restrictions on labor mobility*. A trade deficit can be accompanied by temporary unemployment as workers move from one job to another, but protecting the old jobs is both unnecessary and harmful to national prosperity. (It is most certainly understandable that workers resist having to move from one job to another; such moving can be expensive and inconvenient. But it is in no one's interest for them not to move.)

The Trade Deficit and the Dollar

Eliminating any one part of U.S. imports, even one equal to the deficit, would not do much to prevent the fall in the dollar's foreign exchange value. For example, if the United States suddenly stopped importing oil, it would lose a nearly equivalent dollar inflow from the oil-producing countries, and there would be little net effect on the balance of supply and demand for dollars on the foreign exchange markets.¹⁴

As a further example, if the United States suddenly stopped importing foreign automobiles, there would be increased demand for domestic automobiles. Thus, resources would be diverted from the production of exports, and income would also of course be reduced abroad, thereby reducing the demand for U.S. exports. Again the overall effect on the foreign exchange market is unlikely to be large. Nor would the United

¹¹A more detailed demonstration is contained in the screened insert accompanying this article. The demonstration given there is essentially Ricardo's. As his proof considers only the labor which is involved in production, it is particularly well-suited to show the effect of trade on employment. See David Ricardo, *The Principles of Political Economy and Taxation* (London: J. M. Dent & Sons, Ltd., reprinted 1948), pp. 77-93.

¹²Workers would also have to move around if a country pegged its exchange rate despite having a higher rate of inflation than its trading partners. They would have to do so because pegging the exchange rate would depress both exporting and import-competing industries. Pegging the exchange rate can therefore cause unemployment, but this, too, would be temporary.

¹³There are very special circumstances when it may be advisable to provide assistance to smooth the decline of an industry; but that assistance should never take the form of trade restriction, and should never aim to actually prevent the decline. The arguments for this can be found in Geoffrey E. Wood, "Senile Industry Protection: Comment," *Southern Economic Journal* (January 1975), pp. 535-37.

¹⁴At the end of 1977, U.S. banks reported liabilities of about \$9 billion to Middle East oil exporting countries. These countries also made net purchases of U.S. corporate stocks and bonds and marketable U.S. Treasury bonds and notes totalling about \$7.5 billion during 1977. Further, since these figures omit purchases of land and buildings, they understate the capital inflow. Another large part of OPEC revenue from the United States (some 34 percent) is spent on U.S. goods. (As noted by Clifton B. Luttrell, "Free Trade: A Major Factor in U.S. Farm Income," this *Review* (March 1977), p. 23, agricultural exports rose considerably as a result of OPEC price rises.) Total OPEC spending in the United States is also understated by the amount of U.S. net exports of services to the oil exporting countries. There is good reason for thinking this understatement to be substantial in view of the large jump in U.S. net exports of services after the first major oil price increase. Thus, the simple arithmetic does not support the claim that U.S. imports of oil have produced on foreign exchange markets all the excess supply of dollars which has caused the decline of the dollar's foreign exchange value.

Labor Mobility, The Benefits from Trade, and Employment

For the sake of exposition, we can assume that there are only two countries, the United States and the "rest of the world," and, for simplicity, that there are only two goods, wheat and cloth. In the presence of competition, the price of wheat relative to the price of cloth will be equal to their relative production costs. Suppose that production of a unit of cloth requires the labor of 120 workers for one year in the United States, and that a unit of cloth can be produced in the "rest of the world" with the labor of 80 workers for one year. Production of a given quantity of wheat in the United States requires the labor of 100 workers for a year, while the same quantity of wheat could be produced in the "rest of the world" with the labor of 90 workers for a year. Thus, the production of both cloth and wheat requires a smaller expenditure of labor in the "rest of the world" than in the United States.

With labor being the only cost of production and with competitive markets, in the absence of trade the relative price ratio of wheat to cloth in the United States would be equal to the ratio of labor inputs—that is, it would be $100/120$ ($= 5/6$). The corresponding price ratio in the "rest of the world" would be $90/80$ ($= 9/8$).

If trade between the United States and the "rest of the world" opens up, the United States will import cloth and export wheat. The reason is as follows. At the "rest of the world's" price ratio, $9/8$, the United States could exchange one unit of wheat for $9/8$ units of cloth. Hence, the United States could employ 100 workers to produce a unit of wheat and exchange the wheat for a quantity of cloth which would have required the labor of 135 workers to produce domestically. Further, the "rest of the world" could employ 80 workers to produce a unit of cloth and exchange it,

at U.S. prices, for $6/5$ units of wheat. Thus, the "rest of the world" could obtain an amount of wheat, which would have required the labor of 108 workers to produce domestically, for one unit of cloth which it produced by the labor of 80 workers.¹

As production of wheat in the United States rises (and production of cloth declines), workers move out of the U.S. cloth industry and into the wheat industry. Workers in the "rest of the world" on the other hand, move out of the wheat industry and into the cloth industry. As a result of trade both the United States and the "rest of the world" gain in that both countries obtain a unit of each good for a smaller resource expenditure than would be required to produce the same amount of goods in the absence of trade, and can therefore consume (or invest) more. Although the "rest of the world" has been assumed to use less resources in producing every good than does the United States, it still benefits from buying goods produced in the United States.

The example shows that in the absence of restrictions on labor moving from one industry to another within a country, all who want to work will find employment, even in a country where production costs are higher than those in the rest of the world. Further, it also shows that as a consequence of trade they will be better off than they would be without trade. This arises because they specialize according to whatever they can best do. This, of course, is what individuals who wish to maximize their income do on their own initiative.

¹For the sake of brevity, the example speaks of numbers of workers. If wages are higher in one country than in another, this is dealt with by specifying the example in terms of "value-equivalent" labor units. The same result holds.

States have "gained jobs". There would be an increase in the number of jobs in automobile production, but reduced job opportunities in those industries where foreign demand had fallen. Further, such trade restrictions will divert U.S. resources to activities more productively carried out abroad. Piecemeal attacks on the trade deficit will not achieve an improvement in the balance of payments on any significant scale.

Summary and Conclusions

Present concern about the U.S. trade deficit is much greater than the facts justify. When all trade, and not just merchandise trade, is examined, the deficit is, by historical standards, not outstandingly large. Furthermore, the deficit has a most desirable feature. It allows the United States to import investment funds. At the

moment this is desirable from the point of view of both the United States and the countries which are supplying those funds.

The deficit has at most a transitory effect on the overall level of employment in the United States. Jobs will be lost in some industries, but gained in others. So long as resources, including labor, can move fairly freely, a trade deficit does not reduce the overall level of employment. Analysis which points to particular activities which are eliminated as a result of engaging in foreign trade, and then concludes that trade has led to a loss of jobs, implicitly assumes that once resources are in place they can never again move. There are instances when artificial barriers restrict these movements, but the problems that arise are due to these barriers and not to the deficit.

Finally, and perhaps most important, measures aimed at eliminating some particular component of the trade deficit would produce wasteful uses of resources, have little effect on the balance of payments,

and therefore make little contribution to arresting the slide in the dollar's foreign exchange value. Panic attacks on individual components of the trade deficit will do much harm and little good.

APPENDIX

Merchandise Trade Balance:

Exports of goods less imports of goods. Exported agricultural products accounted for about 20 percent of total U.S. merchandise exports in 1977. Imported petroleum accounted for about 30 percent of total U.S. merchandise imports in 1977.

Goods and Services Balance:

Merchandise trade balance plus net exports of services. Internationally "traded" services include banking, insurance, transportation, tourism, military purchases and sales, and receipts of earnings on investments abroad. United States exports of services have exceeded imports for the past 16 years.

Current Account Balance:

Goods and services balance less unilateral transfers. Unilateral transfers include private gifts to foreigners and government foreign assistance grants but exclude military grants. U.S. unilateral transfers to foreigners have averaged about \$4.5 billion per year since 1970.

Capital Account:

Includes changes in U.S. investment abroad and changes in for-

Capital Account:

ign investment in the United States. Purchases of foreign (U.S.) government securities and corporate bonds and stocks are examples of U.S. (foreign) investment abroad (in the United States). An increase in U.S. investment abroad represents a capital outflow (entered into balance-of-payments accounts as a negative item). An increase in foreign investment in the United States represents a capital inflow (entered as a positive item). Since changes in U.S. investment abroad, and foreign investment in the United States, include changes in official reserve assets (such as purchases of U.S. Treasury securities by foreign central banks), the capital account and current account must offset each other (a balancing category, "statistical discrepancy," is required to produce an exact offset in the reported data). Thus, with a current account deficit of \$20.2 billion in 1977, the United States recorded a net capital inflow of \$23.2 billion (and hence a "statistical discrepancy" figure of \$-3.0 billion).

